28 September 2017

Z Energy market update

Z Energy today provided the market with detail on Z's new distribution policy for the 2019 financial year and beyond; the earnings expected from the company's strategy programme; and an update on longer-term strategic considerations.

Z Chief Executive Mike Bennetts said the business was in good shape post the successful integration of the Caltex New Zealand operation and was well into action on the execution of a revised strategy.

With two days remaining in the first half of the financial year, Z's guidance for full year Replacement Cost Operating EBITDAF (replacement cost earnings) remains unchanged at $445 - $475 million. This is in the context of the recovery period for the recent pipeline outage not yet being fully confirmed.

Refinery to Auckland pipeline outage

Mike Bennetts said Z was very disappointed in the incident with Refining New Zealand's Refinery to Auckland Pipeline.

"While the outage was out of Z's control I want to personally acknowledge and apologise for the difficulty and pressure that the pipeline outage placed on our airline customers, and in turn their own customers."

Mike Bennetts said it was too early to determine what the costs might be as a result of the pipeline outage, as there were a number of variables yet to be clarified. He said Z would provide updates on costs when the company was clear on them but, based on what Z currently knows, there is no change to guidance.

He said he was pleased with the way the Z team worked together, including with government and the rest of the industry, to minimise disruption beyond the airline industry.

"The failure of the pipeline and the subsequent impact will quite rightly be the subject of many conversations, which Z will welcome. Z has previously raised the issue of the heavy reliance the country places on this pipeline, including offering a range of possible solutions, and will participate fully in any formal or informal inquiry that comes from this outage."

Debt and gearing

Mike Bennetts said Z was making excellent progress in paying down debt from the Caltex acquisition and would reduce its net debt to replacement cost earnings ratio to 2.0x at the end of the current financial year, one year earlier than the company's original target as announced at acquisition.

Over the deleveraging period, Z varied its previous distribution policy of paying out 80 per cent of replacement cost net profit after tax in favour of a 10 per cent annual growth on a dividend per share basis.

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“We’ve consulted with our shareholders on the future shape of Z’s distribution policy and the ideal gearing for the company. As a result, once Z meets its targeted 2.0x leverage it will moderate the trajectory of reducing debt to reach 1.5x replacement cost earnings by the end of the 2021 financial year.

“A reduction in gearing to 1.5x replacement cost earnings by the end of the 2021 financial year provides Z with future optionality and further de-risks the company,” he said.

Distributions

This increased optionality means Z will be able to reprioritise cash flow currently used for debt repayment from the 2019 financial year, representing a step change in future dividend distributions.

“We have decided that our future dividend policy that prioritises distributions to shareholders (while continuing the deleverage track) which, during the 2019 to 2021 financial years will pay out between 80 – 100 per cent of underlying free cash flow,” said Mike.

Free cash flow is defined as: net cash inflow from operating activities less maintenance capex and principal debt repayments, adjusted for short-term working capital fluctuations.

“The rationale for this policy is simply ‘better with you than us’. This policy rewards investors for their support and sees Z as one of the leading yield stocks across the NZX without the complexity and unpredictability of share buy backs or special dividends.”

Capex

Z also outlined its commitment to working within a fixed base of capital employed for the core business, thus recycling capital to fund growth options which are still available.

“Z is targeting annual integrity capex spend of approximately $40 million per annum with any growth capex to be funded from asset recycling activities from within the business. By way of contrast, Z’s guidance for capex spend for the current financial year is $90 million, inclusive of integrity and growth capex,” said Mike.

“Under the new capital policy, if Z chooses to buy or build a new service station or supply chain asset, we will fund those projects from the sale of other less productive assets.

“This policy reflects Z’s view that it has the asset and capital base it needs to succeed, and that it can work within a fixed base of capital employed while continuing to grow and deliver increasing returns to shareholders.”

Strategy 3.0

Consistent with Z’s commitment to capital recycling, Z’s third iteration of strategy is focused around the theme of capability and productivity.

"Post the Caltex acquisition, Z now has the scale of assets and operations required to drive efficiency through the value chain. What we call Strategy 3.0 is all about ensuring Z's scale drives distinctive performance, particularly across the supply chain and commercial markets," said Mike.

"In developing this strategy we have identified $30 - $35 million of additional value that we are confident will be delivered by the 2020 financial year and be annualised from there onwards."

Mike said this was the dollar value Z was confident in committing to now, though he acknowledged there may be upside and downside risks that manifest through the strategy execution process and in out years.

"The execution of Strategy 3.0 will take a number of years and we will keep the market up-to-date with any material developments as we have done with past strategy workstreams."

Mike Bennetts said the commitment to $30 - $35 million of strategy value comes on top of the $40 - $45 million that will have been realised by the close of this financial year through the synergies created in putting the Z and Caltex operations together.

What is Next (WIN)?

Z also provided the market with a view as to how it is preparing for a longer term future in which there are increasingly diverse forms of transport energy available to consumers.

"We're committed to a cleaner energy future. While we are actively preparing for the changes that the future will inevitably bring – for all companies and industries, not just our own – Z's current core assets are highly strategic and their productive use is critical in powering the New Zealand economy for many years to come."

Mike Bennetts said Z's WIN strategy was focused on the choices available under a range of future change scenarios and then carefully examining where there might be adjacent growth opportunities – either through brand or capability extension.

"We're committed to being thorough and judicious around how we investigate future growth opportunities in an uncertain future and on ensuring clear and deliberate communication with our shareholders in this area."

Mike said Z was in the very early stages of thinking about potential future opportunities but Z has already narrowed its focus to three market spaces which warrant further exploration. These are:

- Low to zero carbon fuels: how might Z participate in the development and commercialisation of renewable transport fuels, particularly for commercial transport operators, e.g. airlines?
- Mobility: how might Z participate in a technology-driven shift to how people choose to move?
- The last mile: with 80 per cent of the population within five kilometres of one of Z's sites, how might Z use its network to participate in the value chain around the supply of goods and services for that most expensive last mile?

"We're acutely aware that to engage strategically around how Z might participate in a range of future scenarios requires new capability inside the company. We have built a small team both to

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drive innovation through the core business and to carefully and methodically analyse options in the three market spaces."

MEVO equity stake

As part of Z's investigation into the future of mobility, the company has made a modest investment of $250,000 in the MEVO electric vehicle ride sharing company.

MEVO is targeting 50 electric hybrid Audi A3 vehicles in Wellington over the next six months which customers can book and access via an app.

Mike Bennetts said MEVO was an exciting start-up which had the potential to become a much more significant mobility platform for urban dwellers.

"This investment enables us to support a highly promising start-up and gain valuable experience in an area directly relevant to our WIN investigations."

MBIE process

Mike said Z was confident it could demonstrate that the New Zealand downstream fuels industry was highly competitive, with low barriers to entry and that returns were fair and reasonable. He said Z would submit to MBIE on their Fuel Market Performance Study by 13 October around two areas of further investigation: a registry for the existing borrow and loan fuel supply arrangements that underpins New Zealand's fuel supply, and the possibility for a liquid wholesale fuel supply market.

"Neither of these areas cause significant concern, although New Zealand's fuel supply has become more and more efficient over the last 30 years and any changes would need to be very carefully considered in order to avoid unintended negative consequences."

Half year results

Z's half year results will be released to the market on the morning of 9 November. Details will follow over the next two weeks.

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